Course correction: Updating E&F asset allocations and policies to meet future objectives

Morneau Shepell Endowments and Foundations Survey
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Introduction

Canadian endowments and foundations (E&Fs) play an important role in society by providing ongoing benefits to social, governmental, educational, and health-related institutions. From the 2008 financial crisis to the current environment of economic uncertainty and stubbornly low interest rates, E&F investment committees have faced some challenging market environments.

To better understand the industry trends and investment challenges confronting E&Fs today, Morneau Shepell is pleased to release our first Endowments and Foundations survey. This survey examines E&F investment and spending policies and offers insights into strategies that E&Fs presently employ and are also considering to meet spending requirements. We hope this document will not only provide useful findings on how E&F portfolios are currently positioned, but also offer examples of new investment strategies that could deliver financial growth and sustainability.
Executive summary

The main challenge facing E&Fs today is striking the right balance between maximizing grant money payouts each year and ensuring that the asset base does not erode due to inflation or other economic factors. Often E&Fs seek to keep the principal amount intact and use the investment income and capital gains earned on the assets to fund planned spending. Although this allows E&Fs to have a longer lasting impact than if the money were spent all at once, this approach does not come without some risk. Unpredictable asset returns each year mean E&Fs cannot ensure that their spending needs will be met and their asset base will not diminish. As a result, steps are taken to reduce the volatility of asset returns while maintaining target levels of spending.

Most of our survey respondents indicated that their biggest concern is whether their investments will generate sufficient returns to meet future spending needs. Associated with this is the sustainability of the current spending level, the volatility of returns, and inflation risk. Although most E&F administrators review their investment policies annually, the results show that the asset mix is fairly stagnant at roughly 60% equity and 40% fixed income, with a small selection of respondents indicating they have allocations towards alternative asset classes. Given that E&F target spending rates are often a fixed absolute amount and current bond yields are below that amount, the gap between expected returns and future spending needs is a concern. These survey results indicate that some E&Fs are meeting the challenge by diversifying fixed income and equity allocations to create a more efficient asset mix to support their spending policies while managing economic uncertainty.
Methodology

The findings in this report come from a survey sent on behalf of Morneau Shepell to 32 endowments and foundations across Canada. Fifty-eight percent of respondents had assets less than $100 million, 11% had assets between $100 million and $250 million, and 31% had assets of more than $250 million. The distribution of respondents varied by sector, with the greatest number being in the education and health sectors.

To better understand the obstacles facing E&Fs and the possibilities for future investment opportunities, the survey asked respondents about the structure and implementation of their investment and spending policies and the potential for changes to their ongoing asset mixes. Respondents were also asked about their use of external investment consultants and the services these consultants currently provide to E&Fs. The survey results were compiled and are presented throughout this report.
Section 1:
Asset Allocations

Total Fund

Most Canadian E&Fs opt for a traditional 60/40 approach to asset allocation, with 60% of assets dedicated to equity and 35-40% earmarked for fixed income. Although several respondents told us they have devoted a small allocation from both equity and fixed income to fund alternative asset classes such as real estate or infrastructure, Chart 3 shows the 60/40 split remains the predominant investment trend. Also of note is that most respondents indicated they have a heavy weighting towards Canadian equity, with almost an equal split between Canadian and global equity investments.

It is worthwhile to compare the Canadian numbers presented above with the asset allocations of American E&Fs to identify contrasts in investment agendas. According to the National Association of College and University Business Officers and Commonfund Institute (NACUBO), most American E&Fs with assets up to $1 billion and more allocate only about 11% of their portfolios to fixed income investments and 85% to alternative strategies and equity (see Chart 4). The NACUBO also found that the greater the size of assets under management, the larger the allocations in areas such as equities and alternatives.
Unlike the standard 60/40 split adopted by many Canadian E&Fs, most American E&Fs allocate only about 11% of their portfolios to fixed income investments and 85% to alternative strategies and equity.

**Fixed Income**

With prevailing yields on investment grade bonds – and, therefore, projected returns – at or near historic lows, E&Fs are facing increased pressure to deliver planned spending to support their mission based on fixed income instruments. Low yields paired with potentially rising inflation rates means E&Fs may have to rethink traditional modes of investment to create more diverse portfolios to adapt to an ever-changing economic environment.

The responses to our survey indicate a general reluctance to change current portfolios to invest in other asset classes. The chart below highlights this trend with the green bars representing maintenance of the current allocations. In each case, an overwhelming majority of respondents say they are maintaining allocations to various fixed income strategies.

Morneau Shepell projects a fixed income return of about 3.15% over the next 15 to 20 years – a number far lower than the four or five percent spending targets of E&Fs. To fill this gap between spending needs and expected returns, E&Fs should consider adopting broader, more diversified investment strategies that do not rely as heavily on traditional fixed income returns.
Equity Allocations

Equity investments make up the most significant portion of E&F asset allocations. In our survey, 94% of respondents indicated they have Canadian equity in their portfolios, with nearly half (48%) of the average equity asset allocation assigned to Canadian equities – a significant weighting when you consider Canada makes up less than 3% of the world’s economy. Chart 7 shows that only 18.8% of the average asset allocation is invested in US equity and another 32.2% is invested in international and global equity.

Respondents were also asked if they planned to increase, decrease, or maintain their current allocation to each of the equity classes listed. The chart below shows that most E&F managers plan to maintain their current overall equity allocations, although approximately 30% of the respondents have plans to decrease their Canadian equity allocation and redistribute it to other equity classes.
Alternative Assets

Alternative assets add diversity to portfolios and generally include investments such as real estate, infrastructure, commodities, private equity, and hedge funds. Over the last several years, alternatives have grown in popularity and now span a broad spectrum of risk and return. Although they often require large investments and are not always feasible for smaller E&Fs, alternative assets can provide stable cash flows and good potential for long-term growth.

An effective strategy for participating in alternatives is a limited partnership arrangement between the investor and the fund manager. Until recently, Canada Revenue Agency rules prohibited E&Fs from investing in this form. Fortunately, after years of lobbying from various industry groups, the restriction was lifted in the most recent federal budget. This important legislative change offers an enormous opportunity for Canadian E&Fs to broaden and diversify their investment portfolios with alternative assets.

Conversation Starters

Keeping in mind the results of our survey presented above, we offer the following questions for E&F managers to consider as they work to grow their investment portfolios:

- What is the average yield or projected average yield of the portfolio year over year?
- Given the projected yield of fixed income, can we meet spending targets in the long term with our current allocations?
- What portions of our portfolio can be re-positioned to address a low interest environment and a volatile economy?
Section 2: Investment Policy, Spending Policy, and Risk

Developing a clear investment policy with an appropriate amount of risk incorporated into the portfolio is relatively standard practice with large pension funds and institutional investors. Recognizing that E&F investors place a high priority on capital preservation, it is not surprising to learn that nearly 60% of respondents indicated they are eager to achieve a rate of return that exceeds their spending policy without increasing their overall level of risk.

Investment Policy

To keep pace with current industry trends and asset allocations, managers must perform regular reviews of investment policies and procedures. This holds particularly true if an E&F’s asset mix has been updated, alternative asset classes have been added, or risk tolerance and liquidity requirements have changed.

As Chart 9 shows, 80% of our survey respondents indicated that they perform annual reviews of their policies. E&Fs can use these regular reviews to reevaluate their asset mixes, risk tolerance, and investment possibilities, which will help them continue to meet spending targets while confronting current and future financial challenges.

Chart 9: Frequency of investment policy review

- 80.0% of respondents indicated they perform annual reviews.
- 6.7% indicated they perform reviews once every one to three years.
- 13.3% indicated they perform reviews less than once every three years.

38% of respondents were from endowments and foundations that support education.
Spending Policy

E&Fs generally adopt one of two types of spending policies:

- **Flat spending policy**: A flat percentage of the fund’s assets are spent each year.
- **Rolling spending policy**: The spending rate is determined by the return earned by fund assets net of inflation averaged over rolling periods.

To understand which of these approaches E&Fs are currently adopting, we asked respondents if they have a formal spending policy in place and, if so, which of the above policies they use. The following chart shows the results.

Based on today’s historically low-yielding environment in the fixed income space, E&Fs with spending rates in the 4.5-5% range may face significant difficulties in meeting these planned targets. Diversification in the fixed income space, as well as increased allocations to equity and alternatives, may be required for such E&Fs to keep pace.

![Chart 10: Distribution of spending policy methodology](image-url)
Risk

In today’s volatile market, understanding the inherent risk in the portfolio is one of most important steps in any asset allocation decision. E&Fs face the contradictory challenge of maintaining a target spending rate and preserving the real value of the fund while operating in an unpredictable financial environment. While certain investments can come with higher risk, adhering to conservative policies without adapting to new economic situations can also create its own form of hazard for any investor. Striking the right balance between risk and reward is a difficult but crucial element of creating a successful investment strategy that will allow E&Fs to meet their spending and funding goals into the future.

Conversation Starters

The following questions are designed to help E&F managers as they review their investment, spending, and risk management policies:

- Given the uncertainty of markets, should we be increasing the frequency of policy (investment and/or spending) reviews?
- Does the design of the spending policy keep up with our spending obligations while supporting the fund’s desired long-term growth goals?
- Does the asset mix appropriately reflect the spending policy, investment policy, and our tolerance for risk?
- Do the spending and investment policies consider protection of future fund values?
- Do the spending and investment policies expose the fund to degradation over the long term?
- Can we do better by improving our risk profile, sustainability, and our chances for better returns?
Section 3: Use of Investment Consultants

Investment consultants can play a pivotal role for institutional investors. The pace of change for investment strategies and the products available for implementing those strategies is at an all-time high. Lack of expertise and resources can hamper fund managers of E&Fs as they make crucial decisions that will impact sustainability and growth. Consultants can help investors make better decisions about asset allocations and investment possibilities.

Our study reveals that more than 72% of respondents use external investment consultants for guidance in their ongoing operations. To better understand how their consultants are helping them, we asked the respondents who use investment consultants to identify the reasons why they use them. The results are recorded in the chart below.

*Chart 11: Functions of external investment consultants*
While more than 71% of respondents say they employ consultants to review strategic asset allocation and ranges, the results presented in Section 1 of this report suggest that these consultants could be used more effectively to assist with investment strategy beyond the status quo.

**Conversation Starters**
Before hiring investment consultants to guide asset allocation and provide review assistance, E&Fs should consider the following questions:

- What are our primary investment objectives?
- How can an outside investment consultant best achieve those objectives?
- Has this consultant worked with other E&Fs or large institutional investors before?
- What is their track record on diversified portfolio management?
Section 4: Future Challenges

To understand the most important obstacles facing E&Fs, we asked respondents to comment on their major concerns looking ahead. The chart below shows that slightly more than half of the respondents are most anxious about fund returns not being sufficient to achieve the goals of the organization, while high volatility of returns and the risk of increasing levels of inflation are also important considerations.

Given the current trends in asset allocation identified in this report, many E&Fs will need to rethink their investment strategies to meet their target spending objectives in the future. In particular, E&Fs should consider moving away from the traditional model of investment to create a more diversified portfolio better suited to an unpredictable economic environment.
Summary

Morneau Shepell undertook this survey to offer useful findings about the current needs of the E&F community, particularly in the area of investment strategy. The respondents provided invaluable insights into their long-term goals and concerns, as well as their views about their current investment practices and spending policies. The survey results show that fixed income and equity investment allocations are fairly consistent amongst E&Fs. Many respondents indicated they use external investment consultants for a variety of services, including but not limited to the review of investment policies, selection of investment managers, and investment performance monitoring. Consultants offer an important service by providing effective guidance to the E&F community about the risks in its portfolios and how those risks can be mitigated by investing in diversified markets.

The biggest challenge facing any investor – individual or group, small or large, pension plan or E&F – is ensuring returns meet obligations. To achieve long-term spending targets by both preserving and growing their funds, E&Fs should begin to reassess their investment strategies to meet the challenges of an ever-changing and dynamic financial world. Working with E&Fs, Morneau Shepell can provide the necessary education, best practices and forward thinking to steer E&F boards towards greater sustainability of their funds.
Acknowledgments

We wish to take this opportunity to thank the respondents who took the time to participate in our survey. The responses that we received allowed us to deepen our understanding of the current economic landscape in the endowments and foundations space. It has also enabled us to release this report, which we hope will help address organizational challenges and industry trends that endowments and foundations face today.

This survey was produced and conducted by Morneau Shepell’s Asset and Risk Management group. The following individuals were key in the development and production of this report. We invite you to read the report and contact your Morneau Shepell representative with your comments or questions.

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